Making the NFIP Work for Taxpayers and Policy Holders: 
Increasing Consumer Participation

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Making the NFIP Work for Taxpayers and Policyholders:
Increasing Consumer Participation in NFIP

The impact of a consumer’s decision to purchase flood insurance extends well beyond individual households and businesses, having profound and far-reaching implications for communities and federal taxpayers. In communities suffering widespread flooding, the decision to have purchased flood insurance is often the difference between community wide recovery and small businesses closing, residents relocating, and communities enduring a long, uneven recovery hampered by a lack of financial resources.

Mandatory Escrow of Flood Insurance Premiums
To limit the negative financial impact of flooding in areas exposed to higher flood risk, Congress enacted the Flood Disaster Protection Act of 1973 (FDPA)\(^1\) to prohibit federally-regulated financial institutions from extending mortgage credit secured by real property in a Special Flood Hazard Area (SFHA) unless the property is covered by flood insurance. Congress required greater coordination between federal financial regulators on enforcement of the mandatory purchase requirement in the National Flood Insurance Reform Act of 1994\(^2\) and extended the mandatory purchase requirements to loans purchased by the housing government sponsored enterprises, Fannie Mae and Freddie Mac, as well as to mortgages insured or guaranteed by a federal government agency.\(^3\)

In the Biggert Waters Act, Congress built upon these statutes by dramatically increasing civil monetary penalties for financial institutions with a documented pattern or practice of non-compliance with FDPA mandatory purchase requirements. Under the Biggert Waters Act, civil monetary penalties were increased by more than 470 percent, from $350 per occurrence to $2000 per occurrence. Congress also removed the annual limitation on the total amount of penalties a financial institution could face for FDPA noncompliance.\(^4\)

Beginning in the Biggert Waters Act and further refined in the Homeowner Flood Insurance Affordability Act (HFIAA), Congress also required federal financial institution supervisors to adopt rules providing for mandatory escrow of flood insurance premiums. The mandatory escrow requirements became effective January 1, 2016, and covered financial institutions and mortgage servicers must escrow flood insurance premiums for mandatory purchase properties.\(^5\) The escrow requirement is generally enforced at MIRE

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\(^1\) Codified at 42 USC §4001-4129.
\(^2\) P.L. 103-325, Title V (September 23, 1994).
\(^3\) Includes the Federal Housing Administration, the Department of Veterans Affairs, the U.S. Department of Agriculture, and the Small Business Administration.
\(^4\) P.L. 112-141, Title II, Subtitle A, Section 100208.
\(^5\) There are two categories of exemptions to the mandatory escrow requirement: small lender exemptions and loan exemptions. Smaller financial institutions (less than $1 billion in assets) and those institutions that did not previously require establishment of an escrow account for property taxes or hazard insurance are exempted from the mandatory escrow requirement. Loan-related exemptions include junior liens, provided the first-lien mortgage is protected by a flood insurance policy; home equity lines of credit; the loan is primarily for business, commercial, or agricultural purposes; and, mortgages secured by a condominium or cooperative unit, provided the condominium association or cooperative corporation purchases flood insurance for the project and premiums are paid as a common expense. See 12 CFR § 208.25 for regulation adopted by the Board of Governors of the Federal Reserve System, which was also adopted by the other federal financial institution supervisors.
events (when a covered institution makes, increases, renews, or extends a covered loan). Thus, implementation of the mandatory escrow requirement will be on a going-forward basis.

Congress and federal financial institution supervisors further required that financial institutions and mortgage servicers notify consumers with existing mortgages of the option to escrow flood insurance premiums. Pursuant to regulation, covered financial institutions were required to extend this offer to existing mortgagors by July 1, 2016. On an ongoing basis, any financial institution that no longer qualifies for an exemption from the mandatory escrow regulation must notify consumers of the option to escrow flood insurance policy costs by September 30th.⁶

Combined, exponential increases in civil monetary penalties for federally-supervised financial institutions and mandatory escrow of flood insurance premiums for mandatory purchase properties will have a significant, positive impact for consumers and communities. It may be fairly argued that increasing per violation penalties by 470 percent in the Biggert Waters Act was excessive. Notwithstanding this, financial institutions have a clear and ongoing incentive to ensure full compliance with FDPA obligations.

In terms of public policy, mandatory escrow of flood insurance payments is the more impactful of the Biggert Waters Act and HFIAA changes to mandatory purchase implementation requirements. Mandatory escrow will in essence remove the renewal decision from consumers subject to mandatory purchase requirements for the life of the mortgage. This policy also stands to further benefit consumers by avoiding or limiting the occurrences where covered financial institutions and mortgage servicers are required to force place coverage due to a consumer’s failure to maintain flood insurance.

Recommendation:

1. Congress should not additionally increase per violation civil monetary penalties for FDPA violations.

2. Policy makers must allow for a full rollout of mandatory escrow of flood insurance costs (premiums and other policy charges) and NFIP should track and report on consistency of renewals for policies subject to mandatory escrow requirements.

Increasing Participation in Residual Risk and Moderate Risk Areas

Every year, homes and businesses located in areas with lower flood risks are inundated with flood waters. Evidence to support this fact includes FEMA’s determination that 25 percent of annual flood losses occur outside SFHAs⁷ and data showing that approximately one-third of federal flood disaster assistance is allocated to homeowners living outside of designated SFHAs.⁸

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⁶ 12 CFR § 208.25(e)(4)(ii)
⁸ FEMA FloodSmart Flood Facts; accessible at: www.floodsmart.gov/floodsmart/pages/flood_facts.jsp
Further supporting this fact is a comprehensive study conducted by the Wharton Center for Risk Management and Decision Processes. In its study, the Wharton Risk Center examined 1 million NFIP claims from 1980 – 2012 and found that the claim rate for insured SFHA and non-SFHA structures were almost equal. The difference in claims rates was 0.28 percent, a figure that was not statistically significant. Given the equality of claims rates between flood prone areas and areas perceived by consumers to have little or no flood risk, it is imperative that flood insurance coverage levels in such areas improve.

Each home and business in areas with residual flood risks or moderate- to low risk is exposed to loss and these communities will be more resilient if structures are covered by flood insurance. With limited feasible options to compel these property owners to purchase flood insurance coverage, NFIP must persuade consumers to do so. NFIP should examine the process of obtaining flood insurance to determine if there are barriers to consumers taking the decision to purchase flood insurance. NFIP should consider partnerships with states to determine how changes in the process of purchasing flood insurance could improve purchase rates and evaluate strategies to present coverage options to consumers who believe that because they are not required by law to purchase flood insurance they have no exposure to flood risk.

Ease of Purchase
In its report on NFIP affordability, the National Academy of Sciences (NAS) examined the consumer decision making process for solutions to low NFIP participation rates in areas with low to moderate flood risk. NAS offered a persuasive explanation of consumer tendency toward status quo or default options when making purchases.

In the insurance context, NAS cited a case study where consumers in two states were offered reduced automobile insurance premiums in exchange for waiving the right to sue insurers in certain limited circumstances. In one state the default policy waived the right to sue and the default policy in the second state retained the right to sue. In both states, approximately 75 percent of consumers selected the default policy as it was presented to them. Consumers in these states did not exercise options that required them to take additional steps in the purchase of coverage. Ease of purchase appeared to be the controlling factor.

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10 NAS, Report 1, p. 58.

11 The study examined the behavior of automobile insurance consumers in Pennsylvania and New Jersey and the willingness of these consumers to take additional steps to modify the terms of standard automobile insurance policies. Pennsylvania required consumers to modify standard policies in order to receive a premium deduction by surrendering the right to sue the insurer in limited circumstances. New Jersey offered consumers a reduced premium standard policy that limited the consumer's right to sue the insurer, but offered consumers the option to pay higher premiums to retain full rights to sue. In both states, approximately 75 percent of consumers selected the standard policy as it was presented to them. The study's authors concluded that consumers were more likely to purchase the default insurance policy that was offered rather than take additional action to modify the terms of coverage.
The purchase of flood insurance is an inefficient two-step process—flood is an excluded peril in standard hazard insurance policies. Non-mandatory purchase consumers are required to opt-in—to take additional actions—to purchase coverage. NAS has made an effective and compelling case this arrangement results in fewer consumers purchasing coverage than if flood coverage was included in a status quo or default option offered the consumer.

If consumers are more likely to purchase flood insurance offered in coordination with a hazard insurance policy, NFIP must adapt to this consumer behavior. This will require NFIP and state officials to work together so that flood insurance is offered in a manner that is attractive to target consumers and that facilitates the purchase of insurance. NFIP must work proactively to remove barriers to consumer policy purchases.

Constructing a “default” option for the consumer should be a joint effort of NFIP and the National Association of Insurance Commissioners (NAIC). Development of a default flood coverage policy should be authorized by Congress if necessary and ensure that state regulation of insurance pursuant to the McCarran-Ferguson Act remains the law of the land. Alternatively, new product offerings that allow private insurers to take a first loss position backstopped by NFIP could be an option to fundamentally change how flood insurance as a product is presented to the consumer.12

There is a reasonable concern that not all states or all Write Your Own (WYO) companies would choose to offer a “default” policy that allows a consumer to take one action to purchase a hazard insurance policy and an NFIP policy. Additionally, such a default policy is not a force-placed policy and no penalty will or should attach to a consumer who opts to exclude flood insurance coverage. NFIP should engage in a measured and prudential exercise within select states alongside NAIC and WYO partners who choose to participate in constructing a new “default” option for target consumers. Lessons learned from limited offerings may be incorporated in a broader shift in how consumers acquire flood insurance coverage.

Recommendation:

1. NFIP and NAIC should collectively identify impediments to presenting consumers a default policy that allows consumers to take only one action to purchase a hazard policy and an NFIP policy.

2. NFIP should be directed to engage in product testing that offers consumers a “default” insurance option where consumers are required to actively decline (opt-out) flood insurance coverage. Based on the outcome of consumer testing, NFIP and NAIC should move to expand “default” options that include NFIP coverage as appropriate.

Default Policy Options for Residual and Moderate to Low Flood Risk Consumers

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12 For additional information, see CSFI white paper entitled, “Working with Private Capital to Increase Flood Insurance Coverage”.
For residential structures located in residual risk and moderate flood risk zones eligible for a Preferred Risk Policy, state and NFIP officials could facilitate an offer of a standard level of flood insurance coverage to homeowners when a hazard policy is due for renewal. Consumers would not be under obligation to accept the coverage, but an offer with pricing and coverage should be available.

To ease the burden of extending such offers, policymakers could decrease the frequency of flood coverage offers to every two years or offer financial incentives to insurers or insurance agents. If consumers are more likely to purchase coverage presented as a standard option, it is incumbent on NFIP and WYO partners to overcome administrative obstacles that negatively influence a consumer’s purchase decision.

NFIP and states must be mindful of a consumer’s perceived flood risk when constructing a standard option. For example, the Wharton Risk Center found that from 1980 – 2012, 50 percent of all residential flood insurance claims were less than or equal to 10 percent of the property’s value. Further, NFIP data show the historical average flood insurance claim, on a nationwide basis, is approximately $25,000.00 from 1978 through August 2016. When compared with Wharton Risk Center data showing the median claim amount from 1982 – 2012 was $13,000.00, a majority of lower flood risk policyholders would have sufficient claims payments to repair flood damage if covered by the minimum Preferred Risk Policy amount.

Consumers eligible for a Preferred Risk Policy are currently charged $146 in annual premium (approximately $15 per month) for a minimum of $20,000.00 in building and $8,000.00 in contents coverage. For an additional $5.00 in premium insureds could obtain up to $30,000.00 in Increased Cost of Compliance (ICC) coverage. Such coverage is functionally equivalent to the average historical NFIP claim and exceeds the median NFIP claim as calculated by the Wharton Risk Center. For $27 per month consumers could opt to obtain approximately $100,000.00 building coverage and $40,000.00 contents coverage.

While the minimum Preferred Risk Policy will not fully compensate a homeowner for losses in a catastrophic event, this amount of coverage will make a significant contribution toward recovery in most claim scenarios. Consumers would be underinsured in the event of a catastrophic loss, but could exercise the option to purchase additional coverage at their discretion.

In a catastrophic event, consumers who opted for minimal coverage would have access to claims payments, reducing the amount of disaster loans necessary to fully restore their property. Further, catastrophic events often result in damages that trigger mandatory compliance with updated floodplain standards and insureds would have access to ICC claims to offset these costs.

15 Rates obtained at https://www.floodsmart.gov/floodsmart/pages/choose_your_policy/policy_rates.jsp#resprefBCX (accessed 8/26/2016). Note $146.00 (or $151.00 with ICC) does not include additional policy charges.
Policymakers would need to carefully balance the public interest in broadening the risk pool for NFIP and engaging consumers in residual and moderate flood risk areas. Research indicates that not all consumers will opt for even a minimal amount of coverage and will reject a default policy option. Presenting consumers with a default policy option that includes NFIP coverage will still not ensure 100 percent coverage in target areas, but will increase NFIP participation.

Recommendations:

1. **NFIP and state insurance supervisors, working with WYO companies and insurance agents, should facilitate offering a default policy option to consumers living in areas with residual or moderate flood risk a Preferred Risk Policy, with subsequent options and targeted communities developed as appropriate.**

2. For consumers living in areas with residual and moderate flood risk, NFIP and state insurance supervisors, working with WYO companies and insurance agents, should appropriately incentivize offering single purchase options with the opportunity for consumers to opt-out of the default option or to purchase additional coverage if the consumer chooses to protect against catastrophic events.

*Examining Floodplain Designations and Clearly Communicating Flood Risk*

Analysis of NFIP claims data and federal disaster assistance payments data show substantial claims and federal disaster assistance payments flow to areas not designated as SFHAs. Further, data from the Wharton Risk Center show there is little difference between the occurrence of flood loss events in SFHAs and non-SFHAs. Residual and moderate risk consumers suffer a significant portion of flood losses each year, yet research shows fewer than 3 percent of property owners outside designated SFHA purchase flood insurance.16

There is a compelling need for policymakers to reconsider how residual and moderate flood risk is determined and to ensure this risk is clearly communicated to affected consumers. Clear communication of known flood risk to consumers who perceive little to no risk will protect consumer financial interests and reduce future flood risk in communities.

To date, the only demonstrated, effective policy tool to increase flood insurance purchase rates has been the adoption and enforcement of the mandatory purchase standard for mortgaged properties in SFHAs. Policymakers should authorize a study to assess (1) the effectiveness of mandatory purchase in increasing flood insurance coverage and lowering federal disaster expenses, and (2) to identify areas where mandatory purchase of flood insurance coverage would have a positive cost-benefit outcome for taxpayers and consumers. Any study authorized by Congress should engage stakeholders in state and local government, property and casualty insurers, insurance agents, the homebuilding and construction industries, mortgage lenders and servicers, and other interested parties, including homeowners.

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16 Dixon, Lloyd, Noreen Clancy, Seth Seabury, and Adrian Overton, RAND Corporation, *The National Flood Insurance Program’s Market Penetration Rate: Estimates and Implications* (Santa Monica, CA, February 2006), p. 15, Table 4.1
The study should produce recommendations for additional areas of identified flood risk where the benefits of a mandatory purchase requirement clearly outweigh the costs to burdened property owners and communities. Additionally, the study should recommend any new NFIP policy options necessary to meet the needs of expanded mandatory purchase areas (if any) and recommendations on coverage amounts for property owners to recover from average loss events.

Policymakers should also consider mandatory purchase of flood insurance for properties that have incurred flood damage and federal assistance has been used to repair and restore the property. NFIP currently operates a Group Flood Insurance Policy (GFIP) for individuals who, following a presidentially-declared disaster, use federal disaster assistance to repair uninsured flood damage that may serve as a model for policymakers.\textsuperscript{17} GFIPs have a term of 3 years after which time the insured, if subject to mandatory purchase requirements, must purchase and maintain a separate flood insurance policy. Non-mandatory purchase homeowners must maintain NFIP coverage to be eligible for most forms of federal disaster assistance in future disasters.

Mandatory purchase of flood insurance should be extended to GFIP properties where current law and regulation does not mandate continued maintenance of flood insurance coverage. Understanding that flood risks change, the mandatory purchase requirement for such properties should be suspended after a total of [10] years (to begin at GFIP placement) or if subsequent flood risk assessments indicate the property would not be inundated as a result of a substantially similar disaster event (however, prohibitions on future disaster assistance must be maintained). Finally, such a mandatory purchase requirement should attach to the property, not the property owner and duration of the mandatory purchase period conspicuously noted in local land records.

Recommendation:

1. Congress should authorize a study to assess the effectiveness of the mandatory purchase requirement; assess the benefit of mandatory purchase to taxpayers, communities, and households; and identify areas outside designated SFHAs or adjacent thereto where mandatory purchase would have a demonstrable, positive cost-benefit impact for taxpayers and property owners.

2. Congress should consider requiring mandatory purchase of flood insurance for at least [10] years for properties that have experienced a flood loss event and federal disaster assistance was accepted to repair or replace the damaged structure and contents. The mandatory purchase requirement should attach to the structure and the requirement should be noted in local land records in a manner that is readily apparent to title researchers, lenders, appraisers, borrowers, and other parties interested in the transfer of property.

\textsuperscript{17} 44 CFR § 61.17